No. 22093

United States Court of Appeals for the Ninth Circuit

UNITED STATES OF AMERICA,

Appellant,

vs.

LEE HOFFMAN and JUDY HOFFMAN, husband and wife,

Appellees.

On Appeal from the Judgment of the United States District Court for the District of Oregon

BRIEF FOR THE APPELLANT

MITCHELL ROGOVIN,
Assistant Attorney General.

LEE A. JACKSON,
HARRY BAUM,
STEPHEN H. PALEY,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

Of Counsel:
SIDNEY I. LEZAK,
United States Attorney.

GANN PUBLISHING CO., PORTLAND, OREGON 10-24-67

INDEX

INDEX OF CITATIONS
CASES CITED

STATUTES

MISCELLANEOUS

No. 22093

United States Court of Appeals
for the Ninth Circuit

UNITED STATES OF AMERICA,

Appellant,

vs.

LEE HOFFMAN and JUDY HOFFMAN, husband and wife,

Appellees.

On Appeal from the Judgment of the United States District Court for the District of Oregon

BRIEF FOR THE APPELLANT

OPINION BELOW

The opinion and order of the United States District Court for the District of Oregon (R. 78-83) are not officially reported.

JURISDICTION

This appeal involves federal income taxes for the years 1958 through 1961. The taxes in dispute were paid as follows: $6,254.31 on or about October 15, 1959; $2,447.99 on or about April 15, 1960; $2,185.53 on or about April 15, 1961; and $2,056 on or about April 15, 1962. (R. 1-2.) Claims for refund were filed on or about March 29, 1965 (R. 2-3), and were rejected on or about June 29, 1965, except that the claim for refund for the year 1961 was allowed in the amount of $243.99 (R. 3). Within the time provided in Section 6532 of the Internal Revenue Code of 1954, on November 19, 1965, taxpayers brought an action in the District Court for the recovery of taxes paid. (R. 1-22, 94.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. The judgment of the District Court was entered on March 21, 1967. (R. 84, 95.) Within sixty days thereafter, on May 17, 1967, the United States filed a notice of appeal. (R. 85, 95.) On July 10, 1967, the United States filed a motion with the District Court to amend the judgment previously entered. (R. 87-88, 95.) The motion to amend the judgment was denied on July 24, 1967. (R. 92, 95.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether the District Court erred in holding that the losses incurred by the taxpayers (sole stockholder of a corporation and his wife) as indemnitors of the corporation's surety-creditor were

ordinary losses incurred in a transaction entered into for profit though not connected with taxpayers' trade or business within the provisions of Section 165(c)(2) of the Internal Revenue Code of 1954, rather than nonbusiness bad debt losses within the provisions of Section 166(d) deductible only as capital losses.

2. Whether, assuming that there was no debt owing to taxpayers by the corporation by reason of their payments pursuant to the indemnity agreement, the payments represented contributions to the corporate capital deductible only as capital losses within the provisions of Section 165(f) and (g) of the Internal Revenue Code of 1954.

3. Whether, even assuming (as the District Court held) that the losses were incurred in a transaction entered into for profit though not connected with taxpayers' trade or business, within the meaning of Section 165(c)(2), the District Court erred in granting judgment to taxpayers in the amount of $9,345.61, and in failing to grant the motion of the Government to amend the amount of the judgment to $1,812.01 on the ground that such loss cannot be carried back to prior years under the provisions of Section 172 of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and Regulations involved are set out in the Appendix, *infra*.

STATEMENT

The basic facts are undisputed[1] and, as found by the District Court, may be stated as follows:

Taxpayers, Lee and Judy Hoffman, brought this action to recover $9,345.61 in federal income taxes paid for the years 1958 through 1961. (R .78-79.)

Prior to 1958, Lee Hoffman operated a contracting business as sole proprietor. In 1958, he organized Lee Hoffman, Inc., (the "corporation") to operate the existing contracting business. He was the president, director and sole shareholder of the corporation and received a salary for his service as president. (R. 79.)

The General Insurance Company of America (hereinafter sometimes referred to as the Bonding Company), in 1958, agreed to furnish performance and payment bonds for the corporation's construction jobs and taxpayers individually agreed to indemnify the Bonding Company for any loss incurred from having executed the bond. (R. 79-80.)

Lee Hoffman, Inc., obtained construction contracts in 1959 and 1960 from Oak Lodge Sanitary

[1] Taxpayers and the United States both moved for summary judment, and the case was treated as submitted on stipulated facts. (R. 79.)

Districts No. 1 and No. 2, and delivered two payment and performance bonds to the sanitary districts. (R. 80.)

Subsequently, Lee Hoffman, Inc., suffered financial losses. On April 11, 1961, in order to obtain additional funds, the corporation contracted with taxpayers, with the Bonding Company and with the First National Bank of Oregon, whereby the bank agreed to lend money to the corporation if the Bonding Company would request the loan and if taxpayers individually indemnified the bank and the Bonding Company for all sums advanced. Ten days later, taxpayers sold real estate and turned over the entire proceeds, $20,400.83, to the Bonding Company on account of the funds advanced. (R. 80.)

On November 20, 1961, the Bonding Company paid the bank in full for the monies advanced and terminated its agreement with the bank. On the following day, the Bonding Company agreed to advance to the corporation the funds needed to complete its construction contracts and taxpayers individually agreed to indemnify the Bonding Company for any loss resulting from the advances. (R. 80.)

As of November 30, 1962, taxpayers had paid the Bonding Company $3,740. On November 30, 1962, taxpayers transferred $56,283.40 in cash, stocks and realty to the Bonding Company for a release from all liability to the Bonding Company which, at that time was in excess of $900,000. (R. 80-81.)

Taxpayers filed timely refund claims with the Internal Revenue Service with respect to their taxable years 1958-1961, contending that the amounts paid to the Bonding Company in 1961 and 1962 were deductible as ordinary losses within the provisions of Section 165(c)(2) of the Internal Revenue Code of 1954. These claims were rejected by the Internal Revenue Service (R. 81), and this suit for refund followed.

In the District Court, taxpayers contended that the payments to the Bonding Company represented losses incurred in a transaction entered into for profit though not connected with their trade or business, deductible as ordinary losses within the provisions of Section 165(c)(2). The United States contended that the losses were deductible only as capital losses, either as nonbusiness bad debts within provisions of Section 166(d) of the Internal Revenue Code of 1954 or as worthless stock losses within the provisions of Sections 165(f) and (g) of the Internal Revenue Code of 1954. (R. 81.) The District Court sustained the taxpayers' contention that the losses were incurred in a transaction entered into for profit though not connected with their trade or business. (R. 83.) Judgment in the amount of $9,345.61 was entered in favor of taxpayers, and this appeal followed. (R. 84-85.)

Subsequent to the filing of the notice of appeal, the United States moved that the judgment be amended so that taxpayers be awarded $1,812.01 rather than $9,345.61, on the ground that, under Section 172(c) and (d)(4) of the Internal Revenue Code of 1954, losses resulting from a transaction entered into for profit though not connected with a taxpayer's trade or business cannot be carried back and set off against the business income of prior years, as was done by the judgment of the District Court. (R. 87-88.) The Government's motion was denied. (R. 92.)

SPECIFICATION OF ERRORS RELIED UPON

1. The District Court erred in holding that indemnity payments by taxpayers to the corporation's surety-creditor were deductible within the provisions of Section 165(c)(2) of the Internal Revenue Code of 1954 as an ordinary losses incurred in the transaction entered into for profit though not connected with their trade or business, and in failing to hold that the payments resulted in a capital loss either as nonbusiness bad debts within the provisions of Section 166(d) of the Internal Reve-

nue Code of 1954 or as additional contributions to the corporate capital resulting in worthless stock investments within the provisions of Section 165(f) and (g) of the Internal Revenue Code of 1954.

2. In the alternative, and assuming that the losses were incurred in a transaction entered into for profit though not connected with taxpayers' trade or business, the District Court erred in granting judgment to taxpayers in the amount of $9,345.61, and in failing to grant the motion of the United States to amend the judgment to $1,812.01, since such nonbusiness losses cannot, under Section 172 of the Internal Revenue Code of 1954, be carried back to prior tax years.

SUMMARY OF ARGUMENT

The taxpayers, sole stockholder of a construction corporation and his wife, agreed to indemnify a bonding company for any losses resulting from that company's guaranty of performance of the corporation's construction contracts. The corporation suffered financial reverses, the bonding company paid construction creditors of the corporation, the taxpayers indemnified the bonding company pursuant to the indeminty agreement, and the corporation ws unable to reimburse the taxpayers. The Government contended that taxpayers' indemnity payments were deductible as capital losses—either as nonbusiness bad debts under 1954 Code Section 166(d), or as worthless stock losses under Section 165(f) and (g). The District Court, rejecting those contentions, held that the payments were deductible as ordinary losses under Section 165(c)(2). We submit that the District Court clearly erred as a matter of law.

1. Code Section 165(c)(2) authorizes the deduction in full of individual "losses incurred in any transaction entered into for profit, though not connected with a trade or business". However, Section 166(d) requires short-term capital loss treatment "where any nonbusiness debt becomes worthless within the taxable year". In *Putnam v. Commissioner*, 352 U.S. 82, the Supreme Court held (pp. 87-88) that

these sections are mutually exclusive, and that losses incurred by a stockholder as guarantor of loans to his corporation, if deductible at all, are deductible only under the "special limitation provisions" of Section 166(d) relating to nonbusiness bad debts, not under the "general loss provisions" of Section 165(c)(2). The Court pointed out that capital loss treatment of stockholder losses resulting from agreements guaranteeing repayment of third party loans to the corporation is in keeping with the Congressional intent to accord similar treatment to losses sustained by a stockholder who directly advances or contributes funds to an unsuccessful corporation. Under the *Putnam* rationale, the losses sustained by taxpayers by reason of the indemnity agreement here involved constitute nonbusiness bad debt losses within the purview of Section 166(d), and are no less subject to the capital loss limitations imposed by that section than losses resulting from the guaranty agreement there involved.

The District Court deemed *Putnam* inapplicable to a stockholder who enters into an "indemnity" rather than a "guaranty" agreement, apparently on the theory that, unlike a guarantor who is secondarily liable for the corporation, and is subrogated to the rights of the lender-creditor, an indemnitor is primarily liable (together with the borrower-corporation) to the lender-creditor and need not rely on the doctrine of subrogation in seeking reimbursement from the debtor corporation. The theory is untenable for either of two separate reasons: (1) it is clear from decisions of this Court and the Supreme Court of Oregon that an indemnitor under the type of agreement here involved is entitled under Oregon law to be subrogated to the rights of the indemnified creditor; (2) in any event, whether a loss is deductible as an ordinary or capital loss for federal income tax purposes is not dependent on state law distinctions between a "guaranty" and an "indemnity" agreement, so that even in the absence of a right of subrogation a loss incurred by a stockholder-indemnitor is a nonbusiness bad debt loss falling within the purview of Section 166(d) as interpreted in *Putnam*. To permit the federal tax consequence to turn on whether the stockholder's agreement to hold the corporation's creditor harmless is labeled an "indemnity" or a "guaranty" agreement, or on whether under state law his right to reimbursement from the debtor corporation stems from subrogation rather than some other equitable principle, would exalt form over substance, disregard business realities, and violate the fundamental rule that the federal taxing statute is to be applied wherever possible with nationwide uniformity. Nothing in the relevant statutory provisions, their history, the Treasury Regulations, or the controlling decisions warrants the conclusion that Congress intended the nature of the loss here in question—ordinary versus capital—to depend on any formalistic distinctions between a "guarantor" and "indemnitor". On the contrary, as the Supreme Court held in *Putnam*, Congress intended to treat all losses incurred by a stockholder who lends his credit to the corporation —whether in the form of a direct loan, or indirectly as guarantor or indemnitor of third party loans—in the same manner, i.e. as capital losses.

The Congressional intent to treat losses like those here involved as capital losses from nonbusiness bad debts is confirmed by 1954 Code Section 166(f). That section provides for treatment as a business bad debt (deductible in full) of payments made by a taxpayer as a "guarantor, endorser, or indemnitor", but explicitly confines such treatment to the guaranty or indemnity of a "noncorporate obligation". Thus Congress in the 1954 Code not only expressly recognized that losses sustained by "indemnitors"—no less than those sustained by "guarantors"—constitute bad debt losses, but made certain that such losses are subject to capital loss limitations if they result from the payment of a *corporate* obligation by an indemnitor. See also *Putnam, supra,* at pp. 85-86.

The District Court's error is compounded by its misconception of the meaning and scope of the phrase "transaction entered into by an individual for profit", as used in Section 165(c)(2). It mistakenly assumed that because taxpayers' "motive" in agreeing to indemnify the bonding company was to promote the success of the corporation and thereby enable the taxpayer-husband to realize its profits as sole stockholder and salaried president, the indemnity agreement was a "transaction entered into for profit". Any stockholder-officer who agrees to repay a third party's advances to or on behalf of his corporation, whether in the form of a guaranty or an indemnity agreement, is naturally motivated by a desire to enhance the corporate profits and, consequently, his individual income qua stockholder-employee. But, as the Supreme Court held in *Putnam,* such a transaction is not the kind of "transaction entered into for profit" which Section 165(c)(2) was designed to cover. See also *Whipple v. Commissioner,* 373 U.S. 193. Futhermore, taxpayers could not expect individually to realize a "profit" from their agreement to indemnify the creditors of the corporation; any "profit" from such a "transaction" could be realized only indirectly, through benefits to the borrower corporation, not as indemnitors.

2. Even assuming *arguendo* that the nonbusiness bad debt provisions of Section 166(d) are inapplicable, the decision below should nevertheless be reversed on the alternative ground, also advanced by the Government in the District Court, that a

stockholder's reimbursement payments to a creditor of his corporation under a guaranty or indemnity agreement in substance and effect constitute additional contributions to the capital of the corporation, resulting in a worthless stock loss, and that therefore the capital loss provisions of Section 165(f) and (g) come into play. This Court recently so held (*United States v. Keeler,* 308 F.2d 424, certiorari denied, 373 U.S. 933), pointing out that to accord such loss ordinary loss treatment under Section 165(c)(2) would sanction an unrealistic distinction between a stockholder's direct and indirect investments in the corporation, and thus create a tax loophole never intended by Congress. Other courts have similarly so held.

3. Despite its holding that the payments in question were deductible under Section 165(c)(2) as losses incurred by an individual in a "transaction entered into for profit, though not connected with a trade or business", the District Court inconsistently held—by denying the Government's motion to amend the amount of the judgment—that the losses could be treated as "business" losses for purposes of applying the "net operating loss" carryback provisions of Code Section 172(c) and (d)(4). Those sections permit nonbusiness deductions to be offset only against nonbusiness gross income for purposes of computing a "net operating loss". Accordingly, even if (as the District

Court held) the losses in question were ordinary losses "not connected with [the taxpayers'] business", the amount of the net operating loss carryback allowed by the Court was patently excessive and the Government's motion to reduce the amount of the judgment should have been granted. Of course, if, as we contend, the losses are allowable only as capital losses (i.e. as nonbusiness bad debts under Section 166(d) or, alternatively, as worthless stock investments under Section 165(f) and (g)), the judgment below should be reversed.

ARGUMENT

I

The losses incurred by taxpayers as indemnitors of the corporation's creditor were deductible only as nonbusiness bad debts (capital losses) under Section 166(d) of the Internal Revenue code of 1954, not as ordinary losses under section 165 (c)(2)

A. Introduction

The taxpayer[2], president, director and sole stockholder of a corporation, agreed with his wife to indemnify Bonding Company if it would furnish the requisite performance and payment bonds for the

[2] When used in the singular, taxpayer refers to the husband, Lee Hoffman.

corporation's construction jobs. The corporate venture having proved unsuccessful, taxpayers were obliged under the indemnity agreement to repay Bonding Company for the advances which it had made, and were unable to obtain repayment from the corporation. The immediate question presented is whether taxpayers' loss, resulting from their payment to Bonding Company, is deductible in full under Section 165(c)(2) of the Internal Revenue Code of 1954, (Appendix, *infra*) as a loss incurred in a transaction entered into for profit though not connected with a trade or business, as taxpayers contended and the District Court found, or is it a nonbusiness bad debt loss deductible only as a capital loss under Section 166(d) of the Internal Revenue Code of 1954 (Appendix, *infra*) as the government contended.[3] Upon the determination of that issue hinges the answer to a basic question, namely, whether an investor in an unsuccessful corporate venture is entitled to a greater loss deduction for federal income tax purposes if he agrees to indemnify a third party for advances made to the corporation than if he guarantees repayment of such advances or makes direct loans to the corporation.

---

[3] The alternative contention of the United States, i.e., that the losses suffered by taxpayers were losses from the sale or exchange of capital assets within the provisions of Section 165 (f) of the Internal Revenue Code of 1954 will be discussed under Argument II.

The nonbusiness loss suffered by an individual who has lent money to an unsuccessful corporation is treated as a capital loss.[4] The same treatment is given to the nonbusiness loss of an individual who has provided capital for a corporation in the conventional form of purchasing its stock.[5] And, as was recently held by the Supreme Court in *Putnam v. Commissioner,* 352 U.S. 82, the loss incurred by a stockholder as guarantor of loans to his corporation constitutes a nonbusiness bad debt to be treated as a capital loss under Section 166(d).

The District Court, however, in holding for taxpayers, has held that *Putnam* has no application where a contract of indemnity rather than a guarantee agreement is used and that, where an indemnity contract is used, the taxpayer who suffers a loss thereunder is entitled to deduct such loss in full under Section 165(c)(2). The corollary of this holding is that because taxpayer made the necessary operating funds available to the corporation indirectly by agreeing to indemnify Bonding Company, he is entitled to a greater loss deduction than he would have been entitled to had he made the funds available directly, or even in-

---

[4] See Section 166(d) and (e), of the Internal Revenue Code of 1954 (Appendix, *infra*).

[5] See Section 165(f) and (g), of the Internal Revenue Code of 1954 (Appendix, *infra*).

directly by means of a guaranty agreement. Yet, as a practical matter, taxpayer's loss would have been precisely the same if he had lent funds directly to the corporation or had guaranteed loans made by other to the corporation.

It is the Government's position that the losses incurred by taxpayers under the indemnity agreement constituted nonbusiness bad debt losses falling within the purview of Section 166(d), and consequently are no less subject to the capital loss limitations imposed by that section than losses resulting from a direct loan or a guaranty of third party loans. To hold that taxpayers are entitled to a greater loss deduction merely because an indemnity contract as opposed to a guaranty agreement was used would exalt form over substance and make the tax result depend upon a distinction having no relation to the business realities of such transaction. Nothing in the relevant statutory provisions or their history justifies the conclusion that Congress intended to create any such distinction; and the court below erred in drawing the distinction.

B. Nonbusiness bad debt losses are deductible as capital losses under Section 166(d), not as ordinary losses under Section 165(c)(2)

Section 166(d) of the Internal Revenue Code of 1954 provides that nonbusiness bad debt losses are to be considered short-terms capital losses.[6]

---

[6] SEC. 166. BAD DEBTS.

* * *

(d) *Nonbusiness Debts.*—

(1) *General rule.*—In the case of a taxpayer other than a corporation—

(A) subsection (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) *Nonbusiness debt defined.*—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) [as amended by Sec. 8, Technical Amendments Act of 1958, P. L. 85-866, 72 Stat. 1606] a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * *

(26 U.S.C. 1964 ed., Sec. 166.)

The predecessor of Section 166(d), Section 23(k)(4) of the 1939 Code (26 U.S.C. 1952 ed., Sec. 23) was first added to that Code by Section 124(a) of the Revenue Act. of 1942, c. 619, 56 Stat. 798. The purpose of Section 23(k)(4), as stated in the House Ways and Means Committee Report accompanying the 1942 Revenue Bill, was "to remove existing inequities and to improve the procedure through which bad-debt deductions are taken." H. Rep. No. 2333, 77th Cong., 2d Sess., p. 44 (1942-2 Cum. Bull. 372, 408). The effect of Section 23(k)(4) was to subject nonbusiness bad debt losses to the limitations upon capital losses, and thus place them on a tax parity with similar nonbusiness losses which were accorded capital loss treatment.

Prior to the Revenue Act of 1942, in computing an individual's taxable net income, nonbusiness bad debts received more favorable tax treatment than was generally afforded other nonbusiness losses. Thus, an individual's bad debts, whether business or nonbusiness, were deductible in full.[7] On the other hand, only some of an indivdual's nonbusiness losses (other than casuality or theft losses) were deductible, viz., those incurred in transactions entered into for profit.[8]

---

[7] See Section 23 (k) (1), Internal Revenue Code of 1939 (26 U.S.C. 1940 ed., Sec. 23).

[8] Section 23 (e) of the Internal Revenue Code of 1939 (26 U.S.C. 1940 ed., Sec. 23) (predecessor to Section 165 (c) (2) of the Internal Revenue Code of 1954).

Moreover, not all deductible losses were fully deductible. A bad debt loss was deductible only as a capital loss if the debt was evidenced by a corporate security, and like treatment was accorded worthless stock losses and losses from sales or exchanges of capital assets.[9]

The Revenue Act of 1942, by restricting the deduction of nonbusiness bad debts, thus brought the tax treatment of those items into closer conformity with that generally afforded an individual's nonbusiness losses. By limiting the bad debts which an individual might deduct as such to business bad debts, and by requiring nonbusiness bad debts to be treated as capital losses, Congress carved out of the general category of losses a particular class of losses, namely, nonbusiness bad debt losses, and expressly subjected them to capital loss limitations—just as it had previously done (in 1939 Code Sections 23 (g) (2) and (3) and (k) (2) and (3)) with respect to debt and stock interests evidenced by securities. Thus under the statutory pattern which emerged from the 1942 amendments, irrespective of whether a nonbusiness bad debt loss might otherwise qualify for deduction in full under the general provisions of Section 165(c)(2), i.e., as a nonbusiness loss incurred in a transaction entered into for profit, such a loss is deductible only as a capital loss by

[9] See Section 23 (g) (1), (2) and (3) and (k) (2) and (3) of the Internal Revenue Code of 1939 (26 U.S.C. 1940 ed., Sec. 23) (predecessors to Sections 165 (f), (g) and 166 (e)).

virtue of the "special limitation provisions" contained in Section 166(d), not under the "general loss provisions" of Section 165(c)(2), *Putnam v. Commissioner, supra*, pp. 87-88. See also *Spring City Co. v. Commissioner*, 292 U.S. 182.

Accordingly, even assuming, as the District Court held (R. 83), that taxpayers entered into a transaction for profit though not connected with their trade or business when they agreed to indemnify the Bonding Company, the loss resulting from such agreement is nonetheless subject to the capital loss limitations imposed by the special provisions of Section 166(d) if it represented a nonbusiness bad debt loss. Since there can be no question that the loss was of a nonbusiness character,[10] the narrow question which remains—and upon

---

[10] As noted above, the District Court found (R.83) that taxpayers' loss was incurred "in a transaction entered into for profit *though not connected with a trade or business.*" (Emphasis supplied.) And, as to the nonbusiness nature of the loss see *Pokress v. Commissioner*, 234 F.2d 146 (C.A. 5th); *Berwind v. Commissioner*, 211 F.2d 575 (C.A. 2d); *Bodzy v. Commissioner*, 321 F.2d 331 (C.A. 5th); *United States v. Byck*, 325 F.2d 551 (C.A. 5th); *Kelly v. Patterson*, 331 F.2d 753 (C.A. 5th); *Pachella's Estate v. Commissioner*, 310 F.2d 815 (C.A. 3d); *United States v. Keeler*, 308 F.2d 424 (C.A. 9th), certiorari denied, 373 U.S. 932.

The test of whether a debt is or is not incurred in a trade or business is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by Section 165(c) is or is not incurred in a trade or business. *Whipple v. Commissioner*, 373 U.S. 193, 200-201; Treasury Regulations on Income Tax (1954 Code), Section 1.166-5(b) (Appendix, *infra*).

which this case turns—is whether the loss was, as the Government contends, a bad debt loss. If it was, then Section 166(d) applies, not Section 165(c)(2), and taxpayers are entitled only to a capital loss deduction.

C. The losses in question were nonbusiness bad debt losses, since taxpayers were subrogated to the rights of the Bonding Company

In holding that a loss incurred by a stockholder under a guaranty agreement is to be treated as a nonbusiness bad debt, the Supreme Court in *Putnam v. Commissioner, supra,* stated (pp. 92-93):

> The loss he sustained when his stock became worthless, as well as the losses from the worthlessness of the loans he made directly to the corporation, would receive capital loss treatment; the 1939 Code [as does the 1954 Code] so provides as to nonbusiness losses both from worthless stock investments and from loans to a corporation, whether or not the loans are evidenced by a security. It is clearly a "fairer refelection" of Putnam's 1948 taxable income to treat the instant loss similarly. There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same, and are accomplished by § 23(k)(4) [now 1954 Code § 166 (d)].

The District Court, however, in the instant case, has held the rationale of *Putnam v. Commissioner, supra,* to be inapposite where a contract of indemnity as opposed to a contract of guaranty is involved. (R. 82.) Citing *Howell v. Commissioner,* 69 F.2d 447 (C.A. 8th), certiorari denied, 292 U.S. 654, it based this distinction on the ground that where an indemnity contract is involved, the indemnitor, unlike a guarantor, is not subrogated to the rights of the creditor and thus has no cause of action against the corporate debtor. The District Court further held that, having no right of subrogation, the indemnitors cannot treat the loss as a worthless debt because the corporation would owe them no debt.

Howell v. Commissioner, supra, however, did not restrict an indemnitor in all circumstances from being subrogated to the rights of the indemnitee, for, as the Eighth Circuit there stated (p. 451):

> An indemnitor may, under certain circumstances, by virtue of subrogation, acquire the rights of his indemnitee. 60 C.J. 781; *Jones v. Bacon,* 72 Hun. 506, 25 N.Y.S. 212, affirmed 145 N.Y. 446, 40 N.E. 216.

Whether an indemnitor is subrogated to the rights of the indemnitee thus appears to be determined by the terms of the indemnity agreement and/or whether the agreement is actually one of indemnity. The Restatement of the Law of Security, Section 82(1), defines "indemnity" as follows:

> 1. *Indemnity.* A contract of indemnity is one where the promisor agrees to save a promisee harmless from some loss, irrespective of the liability of a third person. In this sense, indemnity is synonymous with insurance.

Continuing, the Restatement distinguishes between a contract of indemnity and one of suretyship (guaranty) the former term often being used interchangeably with the latter, although the situation described is the latter. The Restatement states that:

> The indemnitor, upon the happening of the stipulated contingency, is liable whether or not the indemnitee has any recourse against a third person. In suretyship the normal expectation is that the liability will be satisfied by the third person. Indemnity contemplates two parties, at least at the time of making the contract. Suretyship always involves three parties.

Other authorities are to the same effect. For example, Simpson on Suretyship (1950), Section 17, states (pp. 28-29):

> The difference between indemnity and suretyship does not depend upon the use of the word "indemnify" or "guarantee." If C sells goods to P in reliance upon S's promise, whether that promise be in form to "indemnify" C against loss in the event of P's failure to pay, or to "guarantee" C against loss upon

> P's default, in either case S's promise is a promise of guaranty. The real test of a contract of indemnity lies in whether the promisee is an obligee or an obligor, presently or prospectively. If the promise runs to an obligee or to a prospective obligee, as in the above illustration, the contract is guaranty. If the promise runs to an obligor or debtor, the contract is indemnity. For example, if S says to P, "Buy goods from C, and upon your resale of the goods if you suffer loss I will indemnify you," S's contract is a true contract of indemnity.

Simpson, supra, also points out that a situation may occur where there is both a contract of indemnity and of suretyship. For example, if P wishes to borrow from C who refuses to make the loan unless S will guarantee the loan, and S is unwilling to assume the risk of P's insolvency unless T agrees to indemnify or save harmless S from loss on his guarantee, T's contract with S may at once be both indemnity and suretyship, for here T's promisee (S) is both an obligor, as to C, and an obligee, as to P.[11]

---

[11] The only importance of distinguishing between a contract of indemnity and of guaranty or suretyship lies in the fact that a contract of guarantee or suretyship is within the Statute of Frauds, whereas a contract of indemnity is not. As for a promise made to a surety or to one about to become a surety to indemnify him against liability or loss arising from his being or becoming a surety, the Restatement of the Law of Security, Section 96 and the Restatement of the Law of Contracts, Section 186, state such promise to be within the Statute of Frauds if at the time when the promise is made or becomes a contract, the principal also is under a duty to indemnify the surety. This statement is based on the ground that where one promises to indemnify a surety, he is promising to answer for the default of the principal in the event of his failure to perform his obligation or his failure to reimburse the surety, if the latter performs the obligation. See Restatement of the Law of Security, Section 96, Comment c.

This Court, in *Atterbury* v. *Carpenter*, 321 F. 2d 921, described the distinction between an indemnitor and a surety as follows. (pp. 923-924):

> Under a contract of indemnity involving only two parties "the promisor agrees to save a promisee harmless from some loss, irrespective of the liability of a third person." Restatement, Security, § 82, comment 1 (1941). The indemnitor's promise is not conditioned upon another's nonperformance of duty." Arant on Suretyship, § 17 (1931). Liability insurance is the typical example.
>
> The surety, however, promises to protect the promisee only in case a third party, who is primarily liable on the obligation, fails to perform. The creditor-promisee is entitled to compensation from the surety only in the event of default by the principal debtor. Restatement, Security, *supra,* comments f and 1; Arant on Suretyship, *supra,* § 17.[12]

---

[12] In reversing Chief Judge Solomon of the United States Court for the District of Oregon, this Court stated (p. 924):

> The fact that Atterbury agreed "to insure * * * Carpenter against any loss" is not, as the district court thought, inconsistent with suretyship, for the nature of an insurance contract as one involving indemnity or suretyship depends entirely upon the existence of a third party who is primarily liable to the insured. See generally, Restatement, § 82, comment 1.

> The Oregon courts defer to both the Restatement and Arant for the most accurate description of these relationships. See, e.g. *Union Oil Company of California v. Lull* (1960), 220 Or. 412, 425, 349 P. 2d 243, 249.

Howell v. Commissioner, supra, relied upon by the District Court is a classic example of the situation where a true two party indemnity agreement existed. In that case, a bank had acquired certain notes through a firm, the members of which were large stockholders of the bank. Subsequently, members of the firm became involved financially and made an assignment for the benefit of their creditors. Because of the close connection of the firm members with the bank and their financial difficulties, the president of the bank felt that the directors and stockholders should guarantee the bank against loss on the notes. The purpose of the agreement was, as stated by the Eighth Circuit (p. 451):

> * * * to insure the bank to the extent of $200,000 against loss upon the Smith and Ricker paper, and thereby to protect the bank against a possible run and prevent a serious impairment of its assets. There was no intention on the part of the stockholder to acquire the notes or any interest in them or to discharge the obligations of the makers of the notes.

As "neither the bank nor the indemnitors considered that the indemnitors had acquired any interest in these notes by virtue of the payment or that the makers of the notes were obligated to any except the bank" (*Ibid.*), the court held that taxpayer (one of the indemnitors) could not take a deduction for worthless debts as he did not become a creditor of the makers of the notes.

However, in *Jones v. Bacon,* 145 N.Y. 446, 40 N.E. 216, cited by the Eighth Circuit in *Howell v. Commissioner, supra,* as an example of a situation in which an indemnitor may by virtue of subrogation acquire the rights of his indemnitee, action was brought upon a promise made by defendant's testator to indemnify the plaintiff if he would indorse a note for a third party, which the plaintiff thereupon did.[13] The court there held (pp. 450-451):

> The plaintiff having paid the debt in part out of his property, could, prior to the release, have maintained an action against Kingsbury to recover the sum so paid. (citations omitted). The indemnitor of the plaintiff, on restoring to him this sum in performance of the contract of indemnity, would be entitled to be substituted to the claim of the plaintiff against Kingsbury. This stands upon the most obvious principles of natural justice. The money paid by the plaintiff was at the request of Kingsbury, implied from the legal liability as indorser assumed by him, and Kingsbury was bound

[13] The factual situation of *Jones v. Bacon, supra,* and not that of *Howell v. Commissioner, supra* is analogous to the factual situation presented by the instant case. *Jones v. Bacon,* as does the instant proceeding, presents a legal relationship between the parties more akin to that of suretyship or guaranty than a two party indemnity agreement, and where suretyship is involved there is no question but that the right to subrogation exists. Restatement of Security, Section 141; Simpson on Suretyship, Section 47.

> to reimburse the plaintiff. But, by an independent contract between the plaintiff and his indemnitor, McKechnie, the latter was also bound to save the plaintiff harmless. On performance of this obligation by the indemnitor, he would be entitled to stand in the shoes of the plaintiff as to his right to call upon Kingsbury. * * *

This Court has held likewise in *Reid v. Pauly,* 121 Fed. 652. In that case, indemnitors of sureties on the bond of a contractor for the erection of a county building were compelled to pay judgments against the contractor, who was subsequently declared a bankrupt. This Court there held that the indemnitors were entitled to an equitable lien on a balance due from the county to the bankrupt, which the trustee in bankruptcy subsequently recovered, in the amount of the judgments so paid, stating (p. 657):

> And, as indemnitors of the Washington sureties, the complainants, having paid, under compulsion, the debts for which they were bound, are entitled to subrogation, the same as they would have been had they paid them.

The decision of this Court in *Reid v. Pauly, supra,* has been favorably cited by the Supreme Court of Oregon. *Wasco Co. v. New England E. Ins. Co.,* 88 Ore. 465, 172 Pac. 126.[14]

---

[14] On this point see also 60 Corpus Juris 781; Williston on Contracts, Section 1270.

Moreover, the Supreme Court of Oregon (where the instant indemnity agreement was executed) has taken a very liberal view of the right of subrogation. In *United States F. & G. Co. v. Bramwell,* 108 Ore. 261, 277, 217 Pac. 332, 337-338, that court, commenting on the right to subrogation stated:

> It stands upon the same broad principles of natural justice that makes one surety entitled to contribution from another, and is broad enough to cover every instance in which one party is required to pay a debt for which another is primarily answerable, and which, in equity and good conscience, ought to be discharged by the latter. It is a mode which equity adopts to compel the ultimate discharge of a debt by him who in equity and good conscience ought to pay it and relieve him whom none but the creditor could ask to pay, and, when one has been compelled to pay a debt which ought to have been paid by another, he is entitled to exercise all of the remedies which the creditor possesses against that other and to indemnity from the fund out of which should have been made the payment which he has made. The right to be subrogated is not dependent upon legal assignment, nor upon contract, agreement, stipulation or privity between the parties to be affected by it; * * *.

Quoting from *Orem v. Wrightson*, 51 Md. 34, the court continued and stated:

> As is said in some of the cases to which we have referred, equity in applying the doctrine of subrogation looks not to the form, but to the

> substance and essence of the transaction. It looks to the *debt* which is to be paid, and not to the *hand* which may hold it, and will see that the fund charged with its payment shall be so applied.

And in *Hult v. Ebinger,* 222 Ore. 169, 189, 352 P. 2d 583, 592, the Supreme Court of Oregon stated:

> This Court has recognized that the modern tendency is to expand the remedy of subrogation.

See also *Wasco Co. v. New England E. Ins. Co., supra; Barnes v. Eastern & Western Lbr. Co.,* 205 Ore. 553, 287 P. 2d 929; *Fidelity Etc. Co. v. State Bank of Portland,* 117 Ore. 1, 242 Pac. 823; *Schiska v. Schramm,* 151 Ore. 647, 51 P. 2d 668; *Amer. Surety Co. v. Multnomah County,* 171 Ore. 287, 138 P. 2d 597.

Thus, under the decisional law of Oregon and of this Court, taxpayers would be subrogated to the rights of the Bonding Company and the loss which they incurred from entering into the indemnity agreement is limited by Section 166(d) to a nonbusiness bad debt deduction subject to capital loss treatment. *Putnam v. Commissioner,* 352 U.S. 82.

Moreover, to treat taxpayers' loss as a nonbusiness bad debt is in conformity with the manner in which the parties themselves treated the transaction.

First, in the original income tax return filed by taxpayers for the year 1961, they failed to report as salary $11,300 received by them from Lee Hoffman, Inc. (Ex. D attached to defendant's cross motion for summary judgment). It was not until an amended return was filed in conjunction with taxpayers' claim for refund which is the subject of this suit that the amount was reported as salary income. (Compl. Ex. B, R. 13.) Apparently that taxpayers were not attempting to avoid tax by failing to report the $11,300 in their original 1961 return, but were treating it as a non-taxable repayment of an indebtedness owing them by the corporation by virtue of the payment made by them to the Bonding Company under the indemnity and the loan agreements.

Second, on or about November 30, 1962, taxpayers entered into an agreement whereby they were released from all liability to the Bonding Company in consideration for the transfer of certain property to the Bonding Company (Ex. 4 attached to taxpayers' motion for summary judgment). The agreement, in part, provided as follows (p. 1):

> INDEMNITORS are *indebted to BANK and GENERAL as guarantors* of certain obligations of Lee Hoffman, Inc., an Oregon corporation of Beaverton, Oregon, in an aggregate amount in excess of Nine Hundred Thousand and No/100 Dollars ($900,000). This *indebtedness arises out of a guarantee* given

> upon certain notes to BANK, certain agreements of indemnity in favor of GENERAL in connection with bonds of Lee Hoffman, Inc., an agreement dated April 11, 1961 in favor of BANK and GENERAL, and a subsequent agreement dated November 22, 1961 in favor of GENERAL. (Emphasis supplied.)

Although substance, not form, is determinative of the true nature of the agreements entered into by taxpayers, in determining their substance it is relevant to note how the parties themselves ultimately characterized and treated their relationship—as creating an "indebtedness" arising out of a "guarantee."

Third, the agreement of April 11, 1961, between taxpayers, Lee Hoffman, Inc., the Bonding Company and the First National Bank (Ex. 2 attached to taxpayers' motion for summary judgment) and the agreement of November 22, 1961, between taxpayers, Lee Hoffman, Inc., and the Bonding Company (Ex. 3 attached to taxpayers' motion for summary judgment), both referred to above, are reflective of the type of agreement which in *Putnam v. Commissioner, supra,* was held to be one of guarantee (and which gave rise to a nonbusiness bad debt deduction), since they indicate the need of Lee Hoffman, Inc., for additional working capital, taxpayers and the corporation each agreeing to repay the amounts so advanced. For example, the April 11, 1961, agreement provides in part that (pp. 1, 3):

WHEREAS, because of CONTRACTOR'S [corporation's] inability to collect certain accounts receivable which CONTRACTOR feels are due it on account of PROJECTS, CONTRACTOR is unable to continue work on PROJECTS without financial help, and has asked GENERAL [Bonding Company] to assist CONTRACTOR in procuring additional financing to complete the work under said PROJECTS; and

*   *   *

1. BANK agrees, upon request of GENERAL, to loan CONTRACTOR such amounts, not to exceed in total the sum of $300,000 at any one time ***.

*   *   *

6. CONTRACTOR and INDEMNITORS agree to repay all sums advanced hereunder, and any and all other sums due GENERAL under this agreement or under any agreement of indemnity * * *.

The District Court was therefore in error in holding *Putnam v. Commissioner, supra,* to be inapposite to the instant proceeding on the theory that taxpayers had no right of subrogation to the claims of the Bonding Company against the corporation.

D. Losses incurred by an indemnitor under an indemnity agreement are nonbusiness bad debt losses even if the indemnitor has no right of subrogation

The essence of the District Court's decision in the instant case is that under Section 166 the Government must look to state law to determine whether or not a debt exists—i.e., whether subrogation would be allowed. We have already shown (Part C, *supra*) that taxpayers had the right to be subrogated to the claims of the Bonding Company. This alone, we submit, demands reversal of the decision below. However, the court below committed reversible error for an additional reason. The equality of treatment to which all taxpayers are entitled is thoroughly disrupted by making the application of any particular section of the federal tax law hinge on the characterization of the transaction under state law. "A cardinal principle of Congress in its tax scheme is uniformity, as far as may be." *United States v. Gilbert Associates,* 345 U.S. 361, 364. As stated by the Supreme Court in *Burnet v. Harmel*, 287 U.S. 103, 110:

> Here we are concerned only with the meaning and application of a statute enacted by Congress, in the exercise of its plenary power under the Constitution, to tax income. The exertion of that power is not subject to state control. It is the will of Congress which controls, and the expression of its will in legislation, in the absence of language evidencing a

> different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation. See *Weiss v. Wiener,* 279 U.S. 333, 337; *Burk-Waggoner Oil Assn. v. Hopkins,* 269 U.S. 110; *United States v. Childs,* 266 U.S. 304, 309. State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law. See *Crooks v. Harrelson,* 282 U.S. 55; *Poe v. Seaborn,* 282 U.S. 101; *United States v. Loan & Building Co.,* 278 U.S. 55; *Tyler v. United States,* 281 U.S. 497; see *Von Baumbach v. Sargent Land Co., supra,* 519.

Thus, the determination as to whether a debt exists for purpose of Section 166 should not be a matter controlled by state law.

Moreover, to view the determination as to whether or not a debt exists to be a matter of state law, dependent upon whether the right of subrogation exists, totally disregards the Supreme Court's teaching in *Putnam v. Commissioner, supra,* that the application of the bad debt section does not depend on the mechanics of the transaction. Indeed, the decision of the District Court goes much further than making deductibility hinge on whether a direct loan rather than a guaranty is involved (as was the situation in *Putnam*). Rather, under the District Court's decision deductibility hinges upon the particular type of indemnity, guaranty or suretyship agreement which the taxpayer enters into. Thus, if he acts as a guarantor or as a surety, and local law provides that such a contract creates subrogation, he would be limited to a capital loss by Section 166(d). On the other hand, if his agreement constitutes him an indemnitor and local law provides no subrogation, he would not be restricted to a capital loss. But, as was recognized in *Putnam v. Commissioner, supra,* the economic impact of what has been done in each situation is the same, i.e., a corporation, short of funds, has had to look to the credit and financial responsibility of its stockholders as a means of obtaining additional funds. Yet, with virtually no difference in substance, radically different tax treatment is afforded the stockholders.

In addition, the District Court's reasoning may well invite attempts by taxpayers to change capital losses into ordinary losses almost at will. Assume for example that in a guaranty agreement such as was used in *Putnam v. Commissioner, supra,* the taxpayer-guarantor waived his right to be subrogated to the claims of the guarantee.[15] As the right to subrogation is usually worthless in these types of cases (*Putnam v. Commissioner, supra,* p. 89),[16] the taxpayer-guarantor would

---

[15] See Monkoff, Deductions of Indemnity Losses under Section 165, 50 A.B.A. Jour. 782, 783 (1954) wherein the author advises that no right of subrogation nor possibility thereof, be included in an indemnity agreement.

[16] In many situations where a guaranty agreement is involved, not only is the right of subrogation worthless, but in fact, although the guarantor has the bare legal right to be subrogated to the rights of the guarantee, the principal debtor is

be giving up nothing of value, but, would under the decision of the District Court be able to take an ordinary loss rather than a more limited capital loss as the right of subrogation would be lacking and there would, according to the District Court, be no "debt."

The Government contends therefore that bad debts within Section 166 include not only debts created by direct loans, but by any indirect endorsement or other type of arrangement which creates secondary or primary liability on the part of a corporate stockholder, whether or not the stockholder has the right of subrogation. If such a view is adopted, taxpayers, regardless of the status of local law, will be afforded the same tax treatment irrespective of the secondary methods by which they chose to financially support their corporation.

Section 166 itself supports this argument. As noted previously, Section 166(d) imposes the basic restriction on individual taxpayers with regard to business

---

no longer in existence. The Supreme Court, in *Putnam v. Commissioner, supra,* in considering this factor stated (p. 93, fn. 21):

> Upon this ground, contrary to the holding in *Fox v. Commissioner,* 190 F. 2d 101, the guarantor's nonbusiness loss would receive short-term capital loss treatment despite the nonexistence of the debtor at the time of the guarantor's payment to the creditor.

Thus, that the right of subrogation may exist, if at all, in name only demonstrates that the Supreme Court's holding did not depend entirely on the existence of the usually meaningless right of subrogation.

versus nonbusiness bad debts. Although no definition is contained in Section 166(d) of a nonbusiness bad debt, the Congressional intent to preclude deduction in full of losses like that here involved, and to treat them as nonbusiness bad debts, has been confirmed by and carried over into the Internal Revenue Code of 1954. Section 166(f) of the Internal Revenue Code of 1954[17] (Appendix, *infra*) provides for treatment as a business bad debt (i.e., deduction in full) of payments made by a taxpayer as a "guarantor, endorser, or indemnitor," but explicitly confines such treatment to the guarantor, endorser or indemnitor of a "non-corporate obligation." Thus, Congress in the 1954 Code not only expressly recognized that losses sustained by guarantors, endorsers and indemnitors constitute bad debt losses, but made certain that they were subject to capital loss limitations if they resulted from being obligated on a corporate debt. *Putnam v. Commissioner, supra*, p. 86. Moreover, the legislative history of Section 166(f) contradicts the idea that to determine whether or not a debt has been created

---

[17] Section 166 (f) provides:

(f) *Guarantor of Certain Noncorporate Obligations.* — A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment.

either the right of subrogation under local law must be examined or else it must be determined whether taxpayer's obligation is "collateral" (a guaranty or endorsement contract) or "direct" (an indemnity agreement). In S. Rep. No. 1622, 83d Cong., 2d Sess., p. 200, 3 U.S.C. Cong. & Adm. News (1954) 4621, 4835, it was stated:

> The term "guarantor, endorser, or indemnitor," includes not only those persons having collateral obligations as guarantors or endorsers but also those persons having direct obligation as indemnitors.
>
> The payment by the taxpayer of such obligation will result in the treatment of such payment as a debt becoming worthless during the taxable year under the general rule of the section and all other rules of the section (other than subsection (d)) become applicable. * * * [i]f the requirements are met, he will obtain a deduction from ordinary income and the nonbusiness bad debt rules of subsection (d) (treating the loss as a short-term capital loss) will not be applicable.

Thus, clearly, Congress considered each of these categories of secondary liability as being the same for purposes of Section 166, and intended that each should be considered as creating a debt for purposes of Section 166(d).

II

Even assuming that code Section 166(d) is inapplicable, the losses would nevertheless be deductible only as capital losses under Section 165(f) and (g), not as ordinary losses under Section 165(c)(2)

Should this Court determine that there was no debt owing to the taxpayers by Lee Hoffman, Inc., and that the loss which taxpayers incurred would therefore not be within Section 166(d), the loss should nevertheless receive capital loss treatment since the sum paid under the indemnity agreement in substance represented contributions to the capital of Lee Hoffman, Inc.

Taxpayers' corporation, as indicated in the loan agreements of April 11, 1961 and November 22, 1961 (Exs. 2 and 3 attached to plaintiffs' motion for summary judgment) was in dire financial condition and lacked the essential working capital to continue operating. The funds advanced first by the bank and later by the Bonding Company, which sums the corporation could not repay, resulted in taxpayers suffering the loss in question when they were called upon to make the loan good.

To hold, however, as did the District Court (R.83), that taxpayers suffered a loss from a transaction entered into for individual profit though not connected with their trade or business within the purview of Section 165(c)(2) requires the finding that taxpayers' "motive in entering into the transaction was primarily profit." *Helvering v. Nat. Grocery Co.*, 304 U.S. 282, 289; see also *United States v. Keeler*, 308 F.2d 424 (C.A. 9th), certiorari denied, 373 U.S. 932; *Arata v. Commissioner*, 277 F.2d 576 (C.A. 2d). Just how entering into an indemnity agreement obligating taxpayers to furnish money to their corporation or to the Bonding Company as needed for the prompt payment of labor and materials used by the corporation when requested to do so by the Bonding Company (Ex. 1 attached to plaintiffs' motion for summary judgment), and how entering into the loan agreements of April 11, 1961 and November 22, 1961 (Exs. 2 and 3 attached to plaintiffs' motion for summary judgment) by which they obligated themselves, along with their corporation, to repay all sums advanced, is a transaction entered into with a profit motivation is left unexplained by the District Court with the exception of the court's statement that taxpayers "could expect substantial profits if the corporation was successful." (R. 81.) We submit that a stockholder's agreement to advance, or repay sums advanced by another to his corporation, from which transaction itself no profit can be derived, is not a transaction entered into for individual profit within the meaning of Section 165(c) (2).[18] Rather, such an

[18] *Shea v. Commissioner*, 36 T.C. 577, affirmed, 327 F.2d 1002 (C.A. 5th); *Rietzke v. Commissioner*, 40 T.C. 443, and *Horner v. Commissioner*, 35 T.C. 231, relied upon by the District Court, are factually distinguishable and are inapposite to the situation presented by the instant proceeding.

agreement represents a capital contribution to the corporate entity, deductible only as a capital loss within the provisions of Section 165(f) and (g) (Appendix, *infra*) when the stock becomes worthless and the agreement is perfomed.[19]

That an indemnity, guaranty or endorsement agreement may be entered into with the intention of preserving or increasing the value of a prior investment, and that it should therefore be treated as a capital contribution, has long been recognized. *Burnet v. Clark,* 287 U.S. 410; *Menihan v. Commissioner,* 79 F.2d 304 (C.A. 2d); *Syer v. United States* (C.A. 4th), decided July 5, 1967 (20 A.F.T.R. 2d 5252); *In re Park's Estate,* 58 F.2d 965 (C.A. 2d); *Estate of McGlothlin v. Commissioner,* 370 F.2d 729 (C.A. 4th). As stated by the Fourth Circuit in *Syer v. United States,*[20] *supra* (p. 5255):

> If the business had prospered and the taxpayer had sold his stock for a profit, he would have reported his profit as a capital gain. A loss

[19] The District Court, in rejecting the applicability of Section 165(f) and (g), stated that Section 165(f) applies only to losses from sales or exchanges of capital assets and that here "there was no 'sale or exchange'." (R. 83.) For Section 165(f) and (g) to be applicable there need not be an actual sale or exchange. See *United States v. Keeler, supra.* And see Treasury Regulations on Income Tax, Section 1.165-5(c) (Appendix, *infra*).

[20] In *Syer,* taxpayer, as a condition to purchasing 49 percent of a corporation's stock, was required to guaranty certain loans and was subsequently called upon to pay the loans under the terms of the guaranty.

> should receive the same treatment. While the losses sought to be deducted were occasioned immediately by his guaranty of the bank loans, his lending his credit was, in every sense, a part of his cost of acquiring the stock.

This Court has recently been confronted with the problem of determining whether a loss under a guaranty agreement was deductible as an ordinary loss under Section 165(c) (2) or as a capital loss under Section 165(f). In *United States v. Keeler, supra,* the taxpayer induced a group of persons (referred to as the Hooker group) to purchase stock in a corporation, in which he held approximately an one-sixth interest, by orally promising to reimburse the group for any loss which they might sustain by reason of their investment. The taxpayer there, as do the taxpayers here, attempted to deduct the resultant loss as one arising from a transaction entered into for profit.[21] The District Court held that the loss should be "treated as a loss upon the purchase of stock," and this Court affirmed, stating (p. 433):

> Considering only the guaranty to the Hooker group as the "transaction" involved in this question, it is clear that the guaranty was not "a transaction entered into for profit" within the meaning of the statute. Under the guarantee, the best taxpayer could hope for was that he would not sustain a loss.***

[21] Taxpayer in *United States v. Keeler,* also made the alternate contention that the loss was incurred in a trade or business, deductible in full under Section 165 (c) (1).

> However, taxpayer contends that the "transaction" to be considered involves his entering into the creation of Northern, from which he hoped to derive a profit, and that the guaranty of the Hooker group's investment in Northern was an integral part of the entire transaction. Assuming this to be true, the profit which taxpayer could hope to realize would lie in the increased value of his investment in Northern, and possibly greater dividends from that investment.

In holding that the loss was deductible only as a capital loss, this Court reasoned as follows (p. 434):

> Now, it is absolutely clear that had the Hooker group sold their stock at a loss and remained unreimbursed, they would have been entitled only to a capital loss deduction for such loss because of Sec. 165(f). Certainly, when the loss passed to taxpayer by virtue of the guaranty agreement, he should be entitled to no more favorable consideration than the original losers. If the guaranty was made to the Hooker group by the taxpayer as a transaction entered into for profit (and it must be regarded as such if taxpayer is to receive any deduction at all for the resultant loss), then it must be regarded as an investment, and the resulting loss must be treated as a loss on investment. Had taxpayer chosen to make his investment by direct purchase of stock, the resultant loss would be a capital loss under 165(f); had he made his investment in the form of a direct loan to the corporation, or by guaranteeing bank loans to the corporation, the loss would have been a nonbusiness bad debt deductible as a capital loss under Sec. 166(d). To hold

> that he is entitled to more favorable treatment because he chose to make his investment in the manner he did, would be entirely unrealistic, and would create a tax loophole that was never intended by Congress. The case of *Putnam v. Commissioner, supra,* supports this reasoning.

The same reasoning is applicable to the present situation. See also *Estate of McGlothlin v. Commissioner, supra.*

III

Even assuming that the District Court's decision is correct, it erred in denying the Government's motion to reduce the amount of the judgment

On March 21, 1967, the District Court entered judgment in favor of taxpayers in the amount of $9,345.61 (R. 84), which was based on the assumption that the losses in question could be carried back to prior years under the provisions of Section 172 of the Internal Revenue Code of 1954 (Appendix, *infra*). Subsequent to the filing of its notice of appeal, the Government moved to amend the judgment award from $9,345.61 to $1,812.01 on the ground that deductions not attributable to a taxpayer's trade or business cannot be carried back to prior years. This motion was denied. (R. 92.)[22] We submit that, even as-

[22] The judgment was entered shortly after the opinion was filed, before the Internal Revenue Service was afforded an opportunity to submit its computation of the amount due under the

suming *arguendo* (as the District Court held) that the losses in question fall within Code Section 165(c) (2), i.e., were incurred in a "transaction entered into for profit, though not connected with a trade or business", the District Court erred in granting judgment to taxpayers in the amount of $9,345.61 and in failing to grant the Government's motion to reduce the amount of the judgment, since the losses cannot under Section 172 of the Internal Revenue Code of 1954 be carried back to prior tax years.

The excess of deductions over gross income for one tax year cannot be carried back and deducted from income of prior years as a matter of right. A loss incurred in one tax year is set off only against income for that year unless Section 172 authorizes the net operating loss to be carried back. See *Libson Shops, Inc. v. Koehler,* 353 U.S. 382. Section 172(c) (Appendix, *infra*) provides that:

> For purposes of this section, the term "net operating loss" means *** the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modification specified in subsection (d).

---

court's ruling. In summarily denying the Government's motion to amend the amount of the judgment, the court suggested that the issue could be raised on appeal, and stated (transcript of Hearing on Motion to Amend Judgment, July 24, 1967):

> I have been reversed before by the Court of Appeals. I am going to deny your motion and let the Court of Appeals reverse me. Tell them to raise it in the Court of Appeals.

Section 172(d) (4) (Appendix, *infra*) in turn states that:

> In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to to the extent of the amount of the gross income not derived from such trade or business.

Thus, in the determining the net operating loss carryback the ordinary deductions allowed under the 1954 Code which are not attributable to the taxpayer's business can be taken into account only to the extent of the ordinary gross income not derived from the business. See also Treasury Regulations on Income Tax (1954 Code), Section 1.172-3(a)(3)(i) (Appendix, *infra*); 5 Mertens, Law of Federal Income Taxation, Section 29.02(b).

In holding for taxpayers, the District Court ruled (R. 83) "that the Hoffmans incurred a loss in a transaction entered into for profit though not connected with their trade or business." Accordingly, even under the court's own holding, the losses in question constituted nonbusiness deductions which could be used only to offset taxpayers' nonbusiness income, not their business income, for purposes of computing a "net operating loss" which could be carried back and offset against income of prior taxable years. The judgment below disregarded the provisions of Section 172, and improperly allowed such a carryback to prior years

(1958-61), resulting in an excessive amount of refund awarded to taxpayers.[28]

[28] If the court agrees with our contention (Points I and II, *supra*) that the losses in question do not represent ordinary losses falling within Section 165 (c) (2), but are capital losses, the issue raised by the motion to amend the amount of the judgment is academic, since the judgment should then be reversed.

CONCLUSION

The decision of the District Court is erroneous and should be reversed. Alternatively, if the decision of the District Court is upheld, the amount of the judgment awarded taxpayers should be reduced from \$9,345.61 to \$1,812.01.

Respectfully submitted,

MITCHELL ROGOVIN,
Assistant Attorney General

LEE A. JACKSON,

HARRY BAUM,

STEPHEN H. PALEY,
Attorneys,
Department of Justice,
Washington, D.C. 20530

Of Counsel:

SIDNEY I. LEZAK,
United States Attorney

OCTOBER, 1967

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: 24th day of October, 1967.

SIDNEY I. LEZAK,
United States Attorney

APPENDIX

Internal Revenue Code of 1954:

SEC. 165. LOSSES.

* * *

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

* * *

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

* * *

(f) *Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) *Worthless Securities.*—

(1) *General rule.*—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) *Security defined.*—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

* * *

(26 U.S.C. 1964 ed., Sec. 165.)

SEC. 166. BAD DEBTS.

* * *

(d) *Nonbusiness Debts.*—

(1) *General rule.*—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) *Nonbusiness debt defined.*—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) [as amended by Sec. 8, Technical Amendments Act of 1958, P. L. 85-866, 72 Stat. 1606] a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) *Worthless Securities.*—This section shall not apply to a debt which is evidenced by a security as defined in section 165(g) (2) (C).

(f) *Guarantor of Certain Noncorporate Obligations.*—A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment.

*　　　　　*　　　　　*

(26 U.S.C. 1964 ed., Sec. 166.)

SEC. 172. NET OPERATING LOSS DEDUCTION.

*　　　　　*　　　　　*

(c) *Net Operating Loss Defined.*—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) *Modifications.*—The modifications referred to in this section are as follows:

*　　　　　*　　　　　*

(4) *Nonbusiness deductions of taxpayers other than corporations.*—In the case of a taxpayer other than a corporation, the deductions

allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business, shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2) (B), and (3) shall be taken into account; and

(C) any deduction allowable under section 165(c) (3) (relating to casuality losses) shall not be taken into account.

* * *

(26 U.S.C. 1964 ed., Sec. 172.)

Treasury Regulations on Income Tax (1954):

§ 1.165-5 Worthless securities.

* * *

(c) *Capital loss.* If any security which is a capital asset becomes wholly worthless at any time during the taxable year, the loss resulting therefrom may be deducted under section 165(a) but only as though it were a loss from a sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g) (1). The amount so allowed as a deduction shall be subject to the limitations upon capital losses described in paragraph (c) (3) of § 1.165-1.

*　　　　*　　　　*

(26 C.F.R., Sec. 1.165-5)

§ 1.166-5 *Nonbusiness debts.*

*　　　　*　　　　*

(b) *Nonbusiness debt defined.* For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See § 1.165-5, relating to losses on worthless securities.

*　　　　　*　　　　　*

(26 C.F.R., Sec. 1.166-5.)

§ 1.172-3 *Net operating loss in case of a taxpayer other than a corporation.*

(a) *Modification of deductions.* A net operating loss is sustained by a taxpayer other than a corporation in any taxable year beginning after December 31, 1953 if and to the extent that, for such year there is an excess of deductions allowed by chapter 1 of the Internal Revenue Code of 1954 over gross income computed thereunder; this rule shall apply even though the loss year is otherwise subject to the Internal Revenue Code of 1939. In determining the excess of deductions over gross income for such purpose—

*　　　　　*　　　　　*

(3) *Nonbusiness deductions*—(i) *Ordinary deductions.* Ordinary nonbusiness deductions shall be taken into account without regard to the amount of business deductions and shall be allowed in full to the extent, but not in excess, of that amount which is the sum of the ordinary nonbusiness gross income and the excess of nonbusiness capital gains over nonbusiness capital losses. See paragraph (c) of this section. For purposes of section 172, nonbusiness deductions and income which are not attributable to, or derived from, a taxpayer's trade or business. Wages and salary constitute income attributable to the taxpayer's trade or business for such purposes.

* * *

(26 C.F.R., Sec. 1.172-3.)